DOW THEORY LETTERS INC.

RICHARD RUSSELL
P.O. Box 1519
San Diego, California

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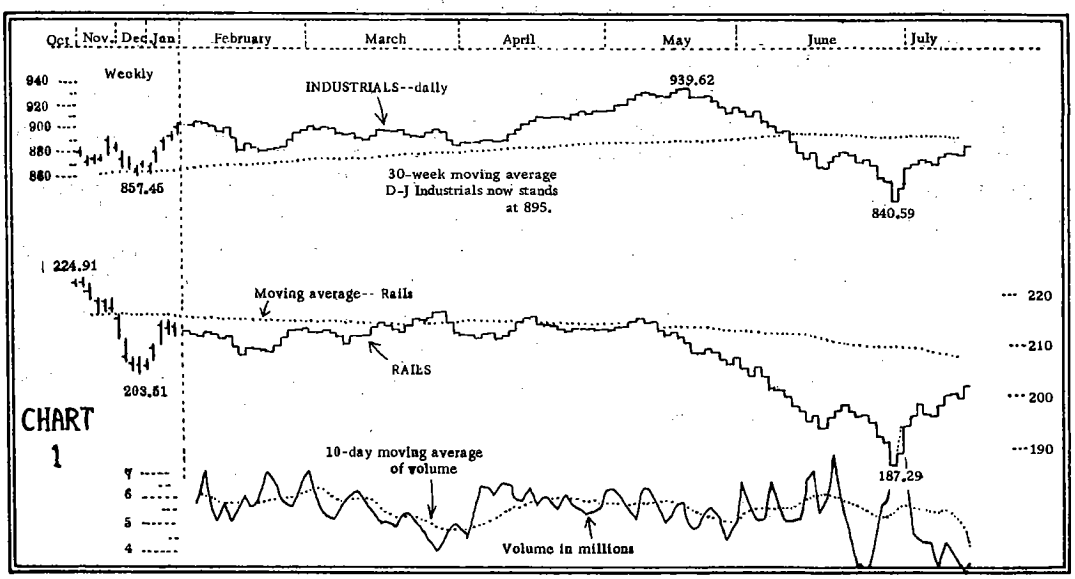
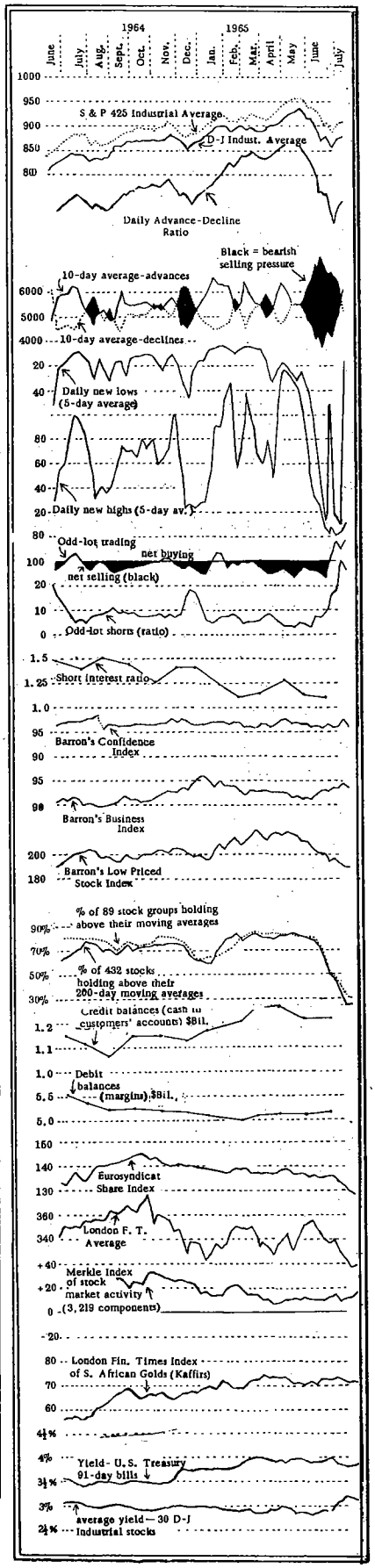
THE MARKET: Following the May 14, 1965, record high of 939.62, the D-J Industrial Average turned abruptly down. An extraordinary straight-line drop of 100 points ensued, terminating with the June 28 low of 840.59 (187.29 for Rails). The subsequent rally began as suddenly as had the decline. Within four trading days Industrials recouped one-third of the losses sustained in the preceding six weeks (May-June).

During the course of the violent decline a Dow Theory bear signal (June 25) was rendered. Wall Street's reaction to the bear signal has been little short of amazing. The rapidity of the May-June decline (which materialized out of a "spearpoint top" in Industrials) obviously caught the investment fraternity completely unaware. The bear signal seemed to have caught Wall Street unaware as well, and the signal was greeted with disbelief, derision and even anger. From all that this writer has been able to gather, investors were preparing for a possible bear market later this year, but the June signal has evidently upset many a "schedule."

I have been studying some of the investment services which arrived here this week, and what they say is so interesting that it is worth commenting upon. I want readers to know that these services are all written by serious and conscientious market students. If what these analysts wrote did not make sense, their services would have "gone by the wayside" years ago. Furthermore, being outstanding market students, these analysts seldom "argue" with the market. They tend to "go with" what the market is saying, and thus a "contrary opinion" on their joint output can be dangerous (in that it may be a contrary opinion against market action itself).

Joseph Granville takes the bear signal very seriously, but feels that it may have aroused too much bearishness on Wall Street. Granville looks for a further (perhaps extended rally), and then real trouble ahead. "Stop living high off the hog," warns Granville in an admonition to readers to get ready for deflation ahead. He adds: "The stock market will no longer carry you." Bolton Tremblay (see last Letter) sees the possibility (but only a possibility) of a double top on the Industrial Average or even a temporary new high. Then he looks for important bear market action over the longer term. E. George Schaefer expects a summer-to-fall "blow off" to new Industrial highs and then a major bear market. In his new report, "The Coming Depression," Schaefer writes: "How low could the Industrial Average go in the next depression? Of course, I don't know, and would only venture a guess. That guess would be down to a minimum of the 350 level, and to a maximum depth of roughly 150. How long would such a primary bear market last? Here again I must only guess — but my guess would be approximately 5 years."





Don Worden ("Worden Tape Reading Studies") feels that there is a chance of a good rally, and his short-term big-block studies tend to support that opinion. However, he states that "we regard this as a bear market." He sees tape action as still very weak, and believes that trading should be strickly on a short-term basis. Anthony Gaubis states that "we believe the probabilities favor a further decline in the market as a whole to approximately 760-790 in the Dow Industrials and then at least a temporary recovery to around the high of 940 touched on May 14th." James Dines avoids "opinions" and lets the market do the talking, but he states that "...the primary trend is down, and any intermediate uptrend will be construed as a rally in a bear market — whether or not new highs are reached." Indicator Digest has received a major "sell signal," and their combined indicator index is now showing only 17% favorable, (the same level it reached in May, 1962). Indicator suggests that "the present advance be treated as the 'sharp oversold' rally we have all been waiting for as a selling opportunity."

THE MARKET, GOLD and the DOLLAR: Few people are aware of the adverse implications that a primary bear market will have for the dollar. A bear market in stocks is almost certain to set off a steady stream of liquidation of U. S. securities by foreigners. Such liquidation will mean dollars in the hands of foreigners instead of stocks, and there is little doubt that a majority of those dollars will be "brought home" in the form of gold. Not only will foreign interests step up their sales (and since mid-1964 they have tended to sell U. S. shares on balance), but a major bear market and business recession will foster fears of a U. S. devaluation (the U. S. might easily wish to "double the value of its gold reserves" by doubling the price of gold in the face of a gathering business collapse). Thus a bear market might "feed on itself" by touching off devaluation fears which in turn would increase foreign selling of U. S. shares (obviously, if stocks were going down and the price of gold was in a position to be raised, there would be every incentive to sell securities and hold gold).

Along these lines it is worth noting that a few weeks ago Britain announced that she is going to convert her holdings of U. S. shares (estimated at about $1.3 billion) into more readily available funds. It is expected that these funds will be largely U. S. Treasury bills. The decision to do this has no doubt been "strengthened" by the May-June drop in the stock market, but the big question is how many other foreign holders will also be thinking of turning U. S. shares into dollars (which may then be converted into gold claims) over the period ahead.

A few other interesting asides on the gold story are as follows: (1) Communist China has been a recent purchaser of gold (estimated amount — $50 to 100 million), and my best sources of information state that China is actually interested in accumulating gold as a profitable hedge against a rise in the price of gold. When it comes to finance, the Chinese can be as "profit-oriented" as the fattest capitalist! (2) According to an estimate by the Federal Reserve Board based on recently published figures, private hoarders drained off all the newly mined gold during the first quarter of 1965 plus an additional $250 million of reserve gold as well. The Reserve Bulletin estimated that the world total of official gold reserves dropped from $43.06 billion to $42.81 billion during the year ending March, 1965 (compared with a year earlier). This means that despite stepped-up gold mining activity (particularly in South Africa), the official world reserves of gold are shrinking instead of growing. Advocates of an increase in the price of gold insist that gold is now the most undervalued commodity in the world today and that the only way to bring vast gold hoardings out into the open is to raise the price of gold.

For all these reasons, I continue to suggest the placing of perhaps 10% of assets in the South African gold stocks (see notes on gold shares in Letter 293). Events, it seems to me, are pointing towards an ultimate increase in the price of gold.

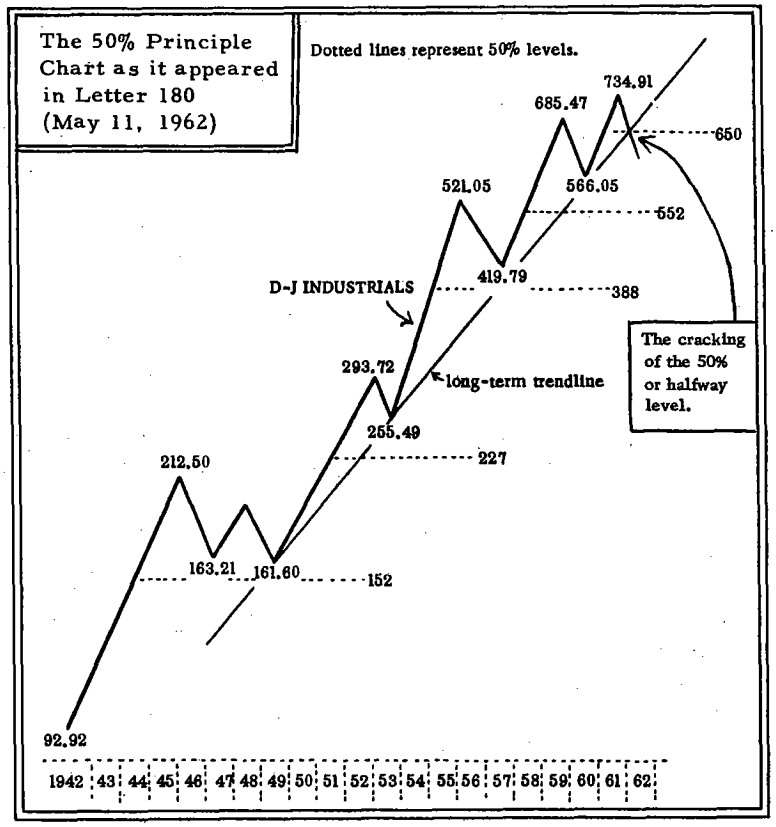
I could expand this section greatly, but I believe this provides a good cross-section of current (highly influential) Wall Street opinion. The crux of these reviews is as follows: a continuation of the rally is expected (with new highs for the Industrials a distinct possibility). Following a substantial rally, the bear market is then expected to reassert itself — perhaps developing into a major bear market within the next six months to a year. Can all these analysts be substantially correct? Can we sell out during August through October in a rallying market and then settle back to watch the trouble? My answer is that all the analysts can indeed be correct. The market has been rallying and it could continue to rally into the fall. And the primary bear trend could reassert itself in the fall, and a great bear leg could then materialize, perhaps cutting the value of the Industrial Average in half within a year.

But I simply cannot advocate acting on this type of "timetable," even if it does prove to be thoroughly correct. Here is why. I had directed subscribers' attentions earlier this year to the "army of technicians and analysts" now at work on Wall Street and throughout the nation. I expressed the view that these men might all be concentrating their attentions' on the same indicators and measurements. Thus, a decline, when it started, could easily gather momentum with little or no warning, and as the decline continued one indicator after the other would turn bearish. This is exactly what occurred after the May 14 top. Now again I hasten to warn readers to be careful, for we have already had a bear signal, a large body of investment opinion is not taking the bear signal seriously, and many are now advocating buying into a bear market. Such procedure can produce profits, but my own instincts run along much more orthodox lines. I would prefer to accept the odds against making money (even during a good rally) in a bear market, and spend my time getting my house in order for what will probably be major trouble ahead.

The Composite Chart (Page 1) shows the two leading industrial averages bouncing well off their June 28 lows, a movement which has been accompanied by comparable action in the A-D ratio. After 37 days of predominant selling pressure (black area), the 10-day average of advances has climbed above declines. This compares with 70 days of continuous selling pressure in 1962. The cessation of selling pressure is confirmed by the sharp contraction in daily new lows. An old "rule of thumb" is that the situation has not basically improved unless new highs can recoup at least half their old peak total. The 1965 peak total for new highs (5-day average) was 149 recorded on April 19. Latest new high reading is 8. Odd-lotters have cut their rate of buying on the rally which is normal. Barron's Confidence Index last week dropped back to 95.9, equal to the previous low for the year. A forthcoming reading below 95.9 would be distinctly bearish. One of the most significant phenomenons of the rally so far is the very low percentage of stocks holding above their moving averages; this figure is now 27%, well below the critical 50% level. The London Average has penetrated a huge (1963-65) "head-and-shoulders" formation (the head and right shoulder appear on the chart). The London Average has thus dropped to its lowest level since 1963, and the eyes of investors all over the world are on Britain and its efforts to support the pound. The future of the pound is considered by many to be the most serious single problem on the investment horizon. The Merkle Index continues to show surprising strength, last week rising to 17, highest level since January. The S. African gold index (Kaffirs) holds in the 71 area, and most of the African gold shares are now within a few percentage points of their highs for the year. Conclusion: short-term indications as shown by the first 8 indicators and the Merkle Index are hopeful. Long term considerations continue to be bearish.

TECHNICAL CRACKS: Back in 1961 and 1962 I wrote frequently about a phenomenon which I termed "Dow's 50% Principle." In the Letter of May 11, 1962 (Letter 180), I issued the following warning: "On May 10 the D-J Industrial Average did something which it has not done in 20 years. The Average broke below the halfway or 50% level of a preceding major advance." In Letter 180 I included a

long-term semi-logarithmic chart showing exactly what had occurred. "As seen on the chart," Letter 180 continued, "the extended bull market rises of 1942-46, 1947-48, 1949-53 and 1957-60 were each followed by major corrections. On each and every one of these corrections the Industrial Average was able to hold above the halfway or 50% level of the preceding major advance. The refusal to penetrate the halfway level held continuing long-term bullish connotations and suggested that the major upward force had not been terminated."



The long-term constructive implications inherent in Dow's 50% Principle were erased during the 1962 collapse. At the time I considered the breaking of the 650 level the first serious crack in the great post-war bull market (and I still hold to that opinion). Nevertheless, as seen by later action the upward momentum of the great bull market was not so easily halted. From the June, 1962 low of 535.76 the Industrial Average embarked on a powerful move which by May 14, 1965, saw that Average at 939.62.

On June 25, 1965, a bear market was signalled according to Dow Theory. A second extremely important blow was thus administered to the market. Despite these two great technical shocks, the market has again "picked itself off its knees" and rallied. Will the upward momentum of the 16 year rise be sufficient to keep the bull forces intact as was the case following 1962? In the opinion of this writer, the answer is no. I believe that a mortal blow was delivered on June 25, 1965, and it is my guess that we are now witnessing the last dieing efforts of the bull forces to assert themselves. I again urge subscribers to adopt the long-term view of this market, and that view is that the great primary bull tide which has swept prices upward since 1949 is breathing its last. By the fall of this year I would expect the bears to be in full command as the market fulcrum tips to the downside and as the powerful bearish forces show themselves plainly for all to see.

INTERNATIONAL CRACKS: Over the past year these Letters have probably devoted more attention to the trend of international markets than any other investment service. I have stressed repeatedly that primary trends tend to be international in scope. With all the markets of the Free World now having "topped out" and heading down, the normal pleasantries and mutual cooperations which were such a "trademark" of the great boom of the 1950's and early 1960's are beginning to deteriorate. This could have the most serious effect on the world economic, political and social picture.

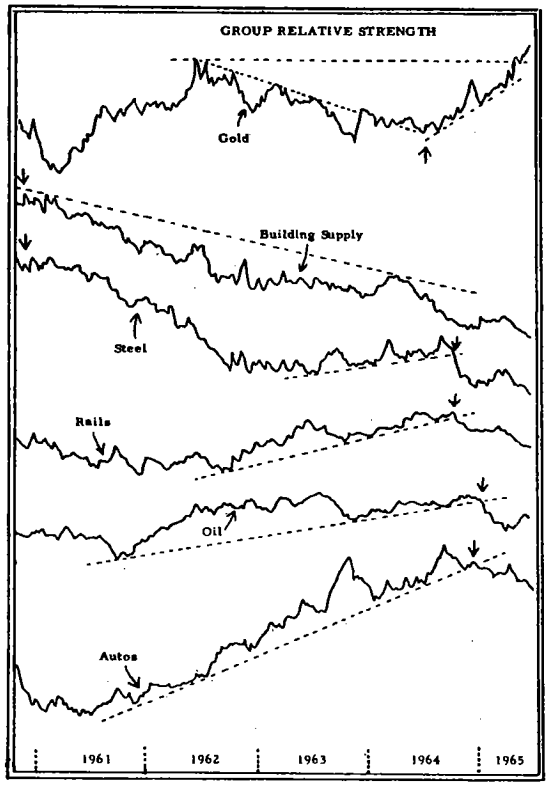
As the major economies of the Free World lapse into recessionary trends, we are already receiving a taste of what could happen in the period ahead. The U. S. is being blamed for much of the current economic trouble, and the complaints center on our policy of cutting back or calling back dollars (this in an attempt to correct our balance-of-payments). But although the dollar repatriation does aggravate the problem of world liquidity (U. S. dollars are used throughout the Free World as reserves under the "gold-exchange system"), the fact remains that the stock markets of Japan, Germany and Italy "topped out" in 1961, France's market turned down in 1962, Switzerland topped in 1963, while London and Australia recorded their highs in 1964. Thus the trouble started long before the shortage of dollars.

In his efforts to block a potential "United States of Europe" and to thwart U. S. leadership in Europe, DeGaulle now threatens to break up the Common Market. It is conceded that it is just a matter of time before France pulls out of NATO and SEATO. The destruction of the Common Market would have the most serious effect on U. S. exports, exports which are already fated to suffer as major European economies contract. A French jettisoning of the current defense systems could play havoc with European nerves, and this type of uncertainty has never been calculated to aid business or commerce. (In the next Letter: Why DeGaulle is willing to run a collision course with the Free World).

Many feel that Japan is leading the way to an international economic "shocker," and there is little doubt but that the dollar shortage has dealt Japan a hard blow. The July 8 Wall Street Journal caught the tenor of the times when it interviewed one top Japanese official (who was angered by the dollar shortage and the U. S. protectionist policies): "If our heavy machinery exports to the U. S. are restricted, we might be forced to look more closely at many license and production agreements granted major U. S. manufacturers here." All of which raises the spector of trade retaliation and trade barriers. A second potential result of the foreign business slowdown could be a policy of "dumping" goods on U. S. markets, and it should be remembered that European and Asian nations have increased their production facilities tremendously over the past 10 years.

Finally, the world wide collapse in commodity prices (for instance, the current 20 year lows in cocoa and sugar) is having the most serious effects on many of the "one-crop" underdeveloped nations. It was the cave-in of world sugar prices which provided the real spark

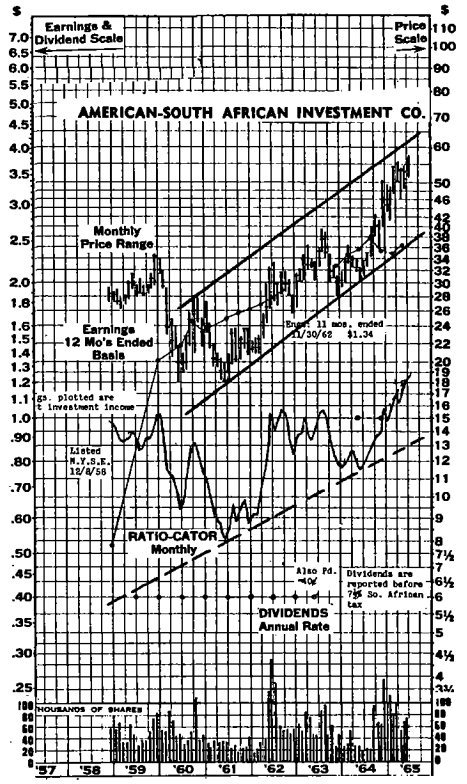
behind the Santo Domingo revolution. On the other side of the world, Ghana, which is the world's leading cocoa producer, is now broke and teetering on the edge of economic chaos.



In this writer's opinion, it is the potential collapse of international cooperation (under the pressure of economic difficulties) which is going to make the next headlines. In fact, we can sense the international irritation as nation after nation gathers up the courage to attack U. S. policy in Santo Domingo and Vietnam. The frontal attack on U. S. foreign policy is something which would not have occurred five or even two years ago; it is symptomatic of the times.

STOCKS: In Letter 290 I included a chart of the relative strength of six significant stock groups. I am bringing these RS charts up to date with this Letter. The Gold group is now the only group making new highs in RS (see notes on ASA below). The golds, led by the S. African issues, have withstood all the recent market weakness and this, of course, has resulted in outstanding RS for the group. Less happy are the profiles of the five other groups which I call the "big guns" of the market. These are the heavy goods groups, the groups which "make" booms and recessions. Building Supplies touched a new low in RS over the past few weeks. Steel is at its low, and the steel shares have performed particularly poorly on the current rally. The Rails are near their low of RS, and the Auto group, having broken its RS line in 1964, continues to drift to new lows. Only the Oils (largely the domestic refiners) have shown signs of acting better than the market. Conclusion: the declining RS trends in these five groups and the rising RS trend in Gold are not an encouraging factor for the market or the economy at this time. If the boom is going to continue, it is hard to visualize it developing any increasing strength in the face of the declining RS trend in these five "heavy gun" groups.

The chart of American South African Investment Co. (ASA) was last shown in Letter 289. Last week ASA pushed out to an all-time high of 58½, no mean feat in the current market. The long term (monthly) chart of ASA shows its performance since first being listed on the N.Y.S.E. in 1958. ASA has developed a six-year rising channel, and since early this year the stock has held within the upper half of the channel. ASA shows a superb RS line (lower line on chart), and recently the RS has confirmed price by rising to an all-time high. The speculative or frothy part of a rise often comes when a stock bursts above the upper channel line on heavy volume, a phenomenon which has not yet occurred in ASA. I would expect such a performance, however, if devaluation (British or world devaluation) becomes a more pressing possibility. In fact, a rush above the upper trendline by ASA could predict just such an event, and would probably constitute a danger signal for the rest of the market (and, in fact, for all world markets).



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Of the 30 D-J Industrial stocks, only 12 are now bullish. These include Alcoa, Amer. Can, Amer. Tob., Bethlehem St., Goodyear, Int. Nickel, Johns-Manville, Owens-Ill., Sears, Texaco, Westinghouse, Woolworth. The four strongest Dow stocks are Alcoa, Can, Tobacco and Goodyear. If the rally extends from here, the four strongest Dow stocks should be in the forefront of the rally, and if I had to pick four stocks for appreciation during a further rally ahead these would comprise my "four stock speculative package."

Subscribers should use rallying periods ahead for purchase of one-year discounted (or below the market) puts as outlined in Letters 290 and 293 (new subscribers may send stamped self-addressed envelopes for copies of these). I have been advocating one-year discounted puts instead of shorts, as my experience is that most subscribers lose money on the short side due to poor timing, psychological pressures and deceptive market movements (this writer just purchased a one-year put on RCA at 34 for $350 — admittedly a bargain, but there will be more of these if the rally continues).

Stocks recommended for one-year puts: GM, Chrysler, Jones & Laughlin, Sears, Northwest Airlines, Pan Amer. World Airways, Fed. Dept. Stores, Assoc. Dry Goods, Celanese, Amer. Enka, N. Y. Central.

LATE NOTES: The Averages are pushing higher, and Wall Street is turning more bullish. But remember, this advance will probably provide us with our last opportunity to purchase puts at advantageous prices (written Thursday, July 15, noon).

Chart of ASA courtesy of Securities Research, 211 Congress Street, Boston, Mass.